

State of California

Public Utilities Commission
San Francisco

M E M O R A N D U M

Date : November 9, 2005

**To : The Commission
(Meeting of November 18, 2005)**

**From : Laurence G. Chaset, PU Counsel IV, Legal Division
Bishu Chatterjee, PURA V, Energy Division**

Subject : Staff Seeks Authority to File Comments in Response to FERC's Notice of Inquiry, Preventing Undue Discrimination and Preference in Transmission Service – FERC Docket No. RM05-25-000, filed September 16, 2005.

INTRODUCTION

Under sections 205 and 206 of the Federal Power Act, the Federal Energy Regulatory Commission (FERC) has a mandate to ensure that, with respect to any transmission in interstate commerce or any sale of electric energy for resale in interstate commerce by a public utility, no person is subject to any undue prejudice or disadvantage. Pursuant to that mandate, in 1996, FERC issued Order No. 888¹ to remedy undue discrimination or preference in access to the monopoly owned transmission wires that control whether and to whom electricity can be transported in interstate commerce.

In Order No. 888, FERC required, as a remedy for undue discrimination in the operation of the transmission systems of public utilities, that all public utilities provide open access transmission service consistent with the terms and conditions of a pro forma open access transmission tariff (OATT). FERC determined that non-discriminatory open access transmission service, including access to transmission information, and stranded cost recovery were the most critical components of a successful transition to competitive wholesale markets.

¹ Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, FERC Stats. & Regs. ¶ 31,036 (1996).

To achieve this, FERC required all public utilities that own, control or operate facilities used for transmitting electric energy in interstate commerce to file OATTs containing certain non-price terms and conditions, and to functionally unbundle wholesale power services from transmission services. With functional unbundling, public utilities would be required to: (1) take wholesale transmission services under the same tariff of general applicability as they offer their customers; (2) state separate rates for wholesale generation, transmission and ancillary services; and (3) rely on the same electronic information network that their transmission customers rely on to obtain information about the utilities' transmission systems.

In its September 19, 2005, Notice of Inquiry (NOI) in Docket No. RM05-25-000, FERC is inviting comments on whether reforms are needed to the Order No. 888 pro forma OATT and the OATTs of public utilities in order to ensure that services thereunder are just, reasonable and not unduly discriminatory or preferential. In this NOI, FERC is also inviting comments on the implementation of Section 1231 of the Energy Policy Act of 2005 (EPAct), which establishes Section 211A of the Federal Power Act (concerning the provision of open access transmission service by unregulated transmitting utilities), as well as on section 1233 of the EPAct, which defines native load service obligation.

FERC's preliminary view is that the pro forma OATT and public utilities' OATTs should be reformed to reflect lessons learned during nearly a decade of the electric utility industry's and FERC's experience with open access transmission. In addition, FERC is concerned that public utility transmission providers have come to different interpretations of provisions of their OATTs and have implemented them in ways that need clarification by FERC to avoid unduly discriminatory or preferential terms and conditions. FERC is accordingly seeking comments on how best to reform these OATTs.

There are a number of important issues relating to current problems in the operations of the transmission grid in California raised by FERC's NOI on which Commission staff would like to comment. Staff is seeking the Commission's authorization to file comments in this docket addressing these issues. Comments are due to FERC on November 22, 2005.

DISCUSSION

Because California's transmission grid is, for the most part, operated by the California Independent System Operator Corporation (CAISO), most of the important examples noted in FERC's NOI of possible discrimination against non-utility users of the transmission systems owned and operated by individual regulated utilities simply do not arise. The major transmission owners whom this Commission directly regulates, PG&E, SCE and SDG&E, participate in the CAISO. By virtue of that participation, these

companies have given up the ability to discriminate against non-utility users of those portions of the CAISO-controlled grid that they continue to own.

However, approximately 20% of California's power is provided by governmental entities unregulated by this Commission, including one very large one, the Los Angeles Department of Water and Power (LADWP), and several other large ones, the Sacramento Municipal Utility District (SMUD) and the Western Area Power Administration (WAPA) – that either do not participate in the CAISO at all (LADWP), or who once did belong to it but have subsequently withdrawn and chosen to form their own control area (SMUD and WAPA). Accordingly, the problems that prompted FERC to issue Order 888 in the first place still exist in connection with these entities that do not participate in the CAISO.

While Order No. 888 set the foundation upon which to attain competitive electric markets, FERC recognized that Order No. 888 did not eliminate the potential to engage in undue discrimination and preference in the provision of transmission service. Accordingly, in its NOI, FERC poses a lengthy set of questions designed to elicit responses addressing the nature and scope of reforms that are necessary to the Order No. 888 pro forma OATT and to the individual public utility OATTs, given the current state of the electric industry and the apparent uncertainties and inconsistent application concerning various tariff provisions that have arisen since implementation of Order No. 888.

Of particular interest to this Commission, in its NOI, FERC is seeking comments on how best to implement Section 1231 of the EPAct, which, as noted above, concerns the provision of open access transmission service by unregulated transmitting utilities, including, but not limited to, municipal utilities such as LADWP and SMUD. There are several major problems resulting from this non-participation in the CAISO of entities such as SMUD and LADWP that call for action by FERC in connection with its anticipated reforms of the Order No. 888 pro forma OATT and the individual public utility OATTs. Commission staff seeks authorization to address these problems in its comments on FERC's NOI as follows.

A. The Calpine Sutter problem

The withdrawal of WAPA from the CAISO in order to join the SMUD control area at the end of 2004 effectively walled Calpine's Sutter plant off from having much of its capacity deliverable to, and usable by, the utilities that participate in the CAISO. The effect of the Sutter plant's new isolation was to reduce liquidity in the CAISO market and, potentially, to increase costs to the utilities' ratepayers. WAPA's action also had the effect of putting at risk the viability of a new, state-of-the-art plant owned by an independent generator, which is entirely contrary to the goals of the OATT.

Although the isolation of the Sutter plant was the most obvious problem resulting from WAPA's withdrawal from the CAISO control area, the CPUC has previously voiced its serious concern to FERC about WAPA's action. See, specifically, the letter dated September 3, 2003, from Michael R. Peevey, the CPUC's President, to Pat Wood, then-Chairman of FERC. In Chairman Wood's response to President Peevey, dated October 2, 2003, he stated his, and FERC's concerns that "the resulting separation of assets could adversely affect reliability by increasing the operational complexity of operating the California-Oregon Intertie." Chairman Wood's response also stated FERC's concerns "regarding the potential increased costs for customers in the West and unnecessary cost-shifting that could result from the formation of an additional control area."

B. Recent Withdrawals from the CAISO

The Modesto Irrigation District (MID), and the owners of the California-Oregon Transmission Project (COTP) have recently chosen to withdraw their facilities from the CAISO and to transfer them to the SMUD control area. In addition, we note that the Turlock Irrigation District (TID) has recently proposed to establish its own control area, independent of either the CAISO or the SMUD/WAPA control areas. These proposed actions, which are still subject to FERC approval, will reduce the footprint of the CAISO, will further balkanize the operation of the transmission grid in California, and could adversely affect the reliability of the CAISO-controlled grid. Moreover, the proposed actions of MID, TID and the owners of the COTP are not in the interest of the ratepayers of those of California's investor-owned and municipal utilities that will continue to have their transmission systems operated by the CAISO.

Proposals such as those of MID, TID and the owners of the COTP create an unnecessary duplication in effort in managing grid operations. Moreover, once implemented, such proposals undermine or eliminate the benefits of the economies of scale resulting from the use of a unified grid operator. Unfortunately, the CAISO has no ability to stop MID, TID and COTP from taking their proposed steps, although the CAISO has openly expressed its concerns about the consequences of these proposed actions.

C. Steps That FERC Should Take Under Section 1231 of the EPA Act

We note that in Section 1231 of the EPA Act, Congress appears to have given FERC explicit authority to require that previously non-jurisdictional transmission owners provide transmission service on a non-preferential and non-discriminatory basis. We recommend that FERC implement this new authority using a three-pronged approach,

including the development of positive incentives, the implementation of mandatory rules, and the establishment of a program of disincentives and penalties.

1. Incentives

In light of the existing Sutter and the looming MID/TID/COTP problems, FERC needs to use the opportunity provided by this rulemaking to implement Section 1231 of the EPAAct by developing a set of positive incentives for non-jurisdictional transmission owners, such as SMUD, WAPA, and in the near future, presumably also MID, TID and the owners of the COTP, to join or re-join an ISO or RTO in order to fully capture the benefits of open access transmission.

In implementing this approach, FERC needs to work closely with the California stakeholders to actively explore the benefits that entities such as the CAISO provide to transmission owners in terms of enhanced reliability, the economic and administrative efficiencies of centralized grid operations and the open and non-discriminatory provision of transmission service. The first goal of this process should be the development of a clear and consensus-based quantification of the benefits of participation in an ISO or RTO. With this initial quantification in hand, the second goal of this process should be the development of a set of specific incentives and policies that can serve to strongly encourage entities such as SMUD, WAPA, MID, TID and the owners of the COTP to see the benefits of participation in the CAISO and to re-join that organization.

2. Mandatory Rules

We note that Section 1231(b) provides that FERC may require, by rule or order, that unregulated transmitting utilities (such as SMUD and WAPA) may be required to provide transmission service:

- (a) at rates that are comparable to those that the unregulated transmitting utility charges itself; and
- (b) on terms and conditions (not relating to rates) that are comparable to those under which the unregulated transmitting utility provides to transmission services to itself and that are not unduly discriminatory or preferential.

In addition, Section 1231(f) provides that

"The rate changing procedures applicable to public utilities under subsections (c) and (d) of section 205 [of the FPA] are

applicable to unregulated transmitting utilities for purposes of this section [211A]."

These requirements appear to give FERC the authority to require previously non-jurisdictional entities, such as SMUD and WAPA, to file tariffs with FERC that would be subject to the due process and the "just and reasonable" requirements of the Federal Power Act. In light of this language, at the same time that FERC is undertaking the voluntary process of identifying the benefits of participation in an ISO/RTO toward the end of incentivizing such participation, FERC should be actively exploring a set of mandatory actions that it may impose on non-jurisdictional entities such as SMUD, WAPA and the rest.

The NOI raises the implementation of Section 1231 as a general matter, asking questions such as whether there should be a generic rulemaking to impose the requirements of this section or whether its implementation should be effected on a case-by-case basis. We think that a generic rulemaking would be the best vehicle for FERC to adopt in order to develop a set of mandatory rules addressing the rates and terms and conditions of service under a pro forma OATT and under entity-specific OATTs.

However, in connection with any such rulemaking, FERC must also be sure to address the pressing question of what should be done to prevent any further balkanization of the California grid. After all, such balkanization runs directly counter to FERC's long-established and clearly enunciated policy in favor of unified grid operations managed by RTOs and ISOs. FERC should accordingly use the opportunity provided by the issuance of its NOI in this proceeding, as well as by the language of Section 1231 of the EPAct, to initiate an investigation (presumably, but not necessarily, via the *sua sponte* establishment of a sub-docket in this proceeding) to affirmatively address the walling off of the Sutter plant and the possible adverse impacts of MID and COTP's pending separation from the CAISO control area. SMUD, WAPA, MID, TID and the owners of the COTP should be made mandatory respondents in this investigation.

3. Disincentives

In light of the Sutter and the MID/COTP problems, FERC also needs to use the opportunity provided by this rulemaking to develop a set of disincentives and/or penalties that would make it more difficult in the future for non-jurisdictional entities such as SMUD and WAPA from leaving control areas, such as the CAISO. Such disincentives and/or penalties should, at a minimum, include the imposition of hefty mandatory surcharges on the use of ISO or RTO-controlled grids by entities that were previously participants in that ISO or RTO, but which subsequently left it to form their own control area or to join a non-jurisdictional control area, such as SMUD's. Ideally, such

disincentives and/or penalties should be structured in such a way as to provide a powerful incentive for SMUD and WAPA to re-join the CAISO.

FERC needs to take serious steps to mitigate the effect, or to prevent future instances, of decisions by entities such as SMUD, WAPA, MID and the owners of the COTP to separate their transmission operations from large, FERC-approved control areas such as that of the CAISO. In this regard, the implementation of Section 1231 is particularly important, because it provides an opportunity for FERC to address more squarely than it has in the past the generic seams issues created by the proliferation of control areas operated by previously unregulated transmission owners and the ability of such entities to "free ride" on the systems and open access requirements of the jurisdictional entities. The implementation of a scheme of disincentives and penalties could prove to be a strong antidote to the elimination of current seams and the creation of new ones, and could ideally eliminate the "free rider" problem altogether.

D. Other Issues

There are a number of other issues raised by FERC's NOI that staff proposes to comment on briefly. These include:

- 1) Open access, by itself, is a great idea, but it has to be implemented in connection with intelligent generation planning and siting policies. Most of these latter are the functions of the states, not FERC. Therefore, any reforms to Order 888 must defer to the states' functions in this regard, and should encourage – but not mandate – state initiatives such as California's Resource Adequacy planning efforts.
- 2) In its Docket RM05-30-000, FERC is addressing the development of the mandatory reliability standards called for in Section 1211 of the EPAct. FERC should coordinate those efforts with its efforts to reform Order 888 in this Docket RM05-25-000 toward the goal of assuring smoother regional oversight over reliability that entities joining (or re-joining) an ISO or RTO could directly benefit from.
- 3) One main purpose of Order 888 was to bring down costs for use of the transmission grid, on the theory that open access transmission would attract least cost generation, thereby resulting in lower costs to ratepayers. Unfortunately, since 1997, we have not seen these benefits in California, where we still experience inter-zonal congestion, load pockets and generation pockets that inhibit the free flow of power that was envisioned by Order 888. The CAISO is working diligently with stakeholders on its MRTU effort, which we expect to be implemented in early 2007. We hope

that the implementation of MRTU will ultimately alleviate the congestion costs that we've seen in California. But in any revisions of Order 888, these same issues that we in California are addressing in the MRTU effort may also have to be addressed. If this turns out to be the case, FERC should not change Order 888 in any way that might contradict or create obstacles for our on-going MRTU effort in California.

- 4) The NOI also calls for comments on the new Native Load Service Obligation provisions of Section 1233 of the EPAct. Specifically, in paragraph 9 of the NOI, FERC asks whether or not the approach that it took in Order 888 is the same as that set forth in section 1233. In this regard, we would note simply that native load will still need to be protected against uncertainties resulting from congestion on the grid by an appropriate allocation of Congestion Revenue Rights (CRRs) rather than by having to compete for such rights in an auction. This is an important issue that we in California are attempting to address in connection with the MRTU process, and FERC needs to make sure that they do not do anything as part of the process of revising Order 888 that might undermine this effort.
- 5) Section N, at pages 26-27 of the NOI, asks whether there is evidence of hoarding or other anti-competitive transmission practices that warrants reform to the OATT. In California, we have had some negative experience with the grandfathering of Existing Transmission Contract (ETCs), especially by certain municipal entities. Under the latest version of MRTU, for municipal entities that participate in the CAISO, we may be able to eliminate this by implementation of a CRR allocation approach and by the "perfect hedge" approach for ETCs. However, even when MRTU is eventually implemented, there may continue to be some hoarding problems on the California grid in connection with the operations of municipal entities that have not turned over operational control of their transmission facilities or that do not participate in the CAISO.
- 6) More transparent reporting should be required from entities, such as SMUD and WAPA, that do not participate in FERC-approved ISOs/RTOs.

ACTION REQUESTED:

Legal Division and Energy Division request authorization to submit comments in FERC's NOI proceedings in Docket RM05-25-000 that are consistent with the foregoing discussion. Since comments will not be due to FERC for two weeks after the preparation of this memorandum, a final draft of staff's proposed comments is not yet available.

However, the final version of staff's comments will simply elaborate upon the points discussed above in more detail.

Assigned Staff: **Laurence Chaset (LAU, 5-5595); Bishu Chatterjee (BBC, 3-1247).**